3rd May 2019

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Via email: intangibles@frc.org.uk

Dear members of the FRC,

Discussion Paper: Business Reporting of Intangibles: Realistic proposals

The Corporate Reporting Users' Forum welcomes the opportunity to comment on the Discussion Paper *Business Reporting of Intangibles: Realistic proposals* Issued by the Financial Reporting Council (FRC) in February 2019.

By way of introduction, CRUF participants are primarily interested in the raw materials needed to build valuation models for specific securities or to consider credit risk, in terms of projected returns, cashflows and prospective risks. The CRUF recognises that the purpose of accounting is to give a true and fair view on the historical performance and position of a business, which is related to, but not the same, as security valuation or credit analysis. Consequentially the divergence between net asset values and market capitalisations is not a concern in itself to CRUF participants and we do not want financial accounting changes to be motivated by a desire to reduce this divergence.

In relation to the reporting of intangibles the CRUF would like to make the following points:

1. The CRUF welcomes improved disclosure on recognised intangible assets to enable users to classify them as either operating intangibles or non-operating intangibles. Please see our response to question 1 for further details.

2. The CRUF welcomes improved disclosure on expenditure which is partially investment in nature, but does not fulfil the conditions to be recognised as an intangible asset. We refer to these expenditures as "revenue investment" which includes research & development, customer acquisition and information technology costs.

3. The CRUF believes that the disclosure of amortisation could be improved. Currently there is no requirement to show where amortisation appears within the income statement. It would be helpful for users if amortisation is disaggregated from depreciation and analysed by both function and nature.

4. The CRUF believes that the disclosure of the tax treatment of amortisation would be helpful in understanding the difference between the P&L tax and the cash tax expenses.

Our specific responses to the questions in the March 2019 presentation to CRUF on the discussion paper are set out below. (The questions are reproduced in italics).

Question 1 Do you agree that it is important to improve the business reporting of intangibles?

The CRUF recognise that intangible assets are increasingly important as economies continue to shift from manufacturing to services. CRUF recognises that balance sheet recognition for a tangible asset is more straightforward than for an intangible asset, which may not be clearly separable and may not necessarily be wholly owned by the company. Nevertheless improved disclosure could help users.

CRUF believes that a classification of intangible assets (other than goodwill) into operating intangibles and non-operating intangibles is important:

- **Operating intangibles** (1) generate identifiable cash flows, (2) can be separated and sold or transferred, and (3) have a consistent accounting treatment if acquired or organically developed. An operating intangible can have a finite or infinite life. Examples include capitalised software, radio licences, patents and distribution rights. Amortisation of operating intangibles should be included as an operating expense when calculating operating performance.

- **Non-operating intangibles** do not satisfy all three criteria for classification as an operating intangible, consequentially they should be treated as equivalent to goodwill. A non-operating intangible can have a finite or infinite life. Examples include customer lists (do not have identifiable cashflows) and brands (financial reporting standards only recognises brands as an asset if acquired, but not if internally developed). Amortisation of non-operating intangibles should be excluded as an operating expense when calculating operating performance.

The CRUF recognises that in practice the distinction between operating intangibles and non-operating intangibles is a matter of judgement. Improved disclosure around identifiable cash flows and separability would help users make their own classification between operating and non-operating intangibles. Justification on why an asset is deemed to have an infinite life, and justification of the choice of useful economic life for a finite life asset would also be helpful to users.

The following examples help illustrate the practical challenges:

A data aggregation company acquires a customer database as part of an acquisition. Under acquisition accounting the database is recognised at fair value as an intangible asset with a finite life. However, the economic reality is that customer databases are not static databases, rather they need to be updated continually to maintain their value. Consequentially there will be ongoing expenditure to collect and add new data to the database. As long as new data is added the database maintains its value in perpetuity. On this basis, amortising the asset does not reflect the economic reality. Including amortisation of this intangible asset and also including the ongoing expenditure to maintain the value of the database would result in an overly prudent view of operating performance.

A pharmaceutical company acquires intellectual property as part of an acquisition. Under acquisition accounting this asset is recognised at fair value as an intangible asset with a finite life. The economic reality is that many large pharmaceutical companies outsource early stages of research and development. In such cases the amortisation of the acquired intellectual property is comparable to the research and development expenditure which would have been incurred if the project had been carried out in-house. Excluding amortisation of the acquired intellectual property asset would result in an overly flattering view of operating performance.

Question 2 Do you agree that an intangible should be recognised at cost under the two conditions set out above in (i)?

Yes, the recognition of a balance sheet asset should fulfil both conditions set out. The CRUF do not believe that it is helpful to relax the criteria for asset recognition conditions to close the gap between net asset value and market capitalisation. Such a move may lead to inconsistent capitalisation of assets and reduce comparability between companies.

Question 3 Do you agree with the assumptions the paper makes regarding measurement uncertainty of intangibles?

The CRUF does not believe that capitalisation of intangible assets should be extended to situations where there is a high degree of uncertainty both with reference to costs and valuation. With respect to costs it is often very difficult to identify the costs when an intangible asset arises from an activity which is partly operational in nature. With respect to valuation it is often very difficult to estimate as many intangible investments are speculative in nature.

Question 4 Do you agree that existing accounting standards should be revisited with the aim of improving the accounting for intangibles?

Yes, the CRUF thinks that improved disclosure on "revenue investment" would be helpful.

Question 5 Do you agree with the above proposals relating to expenditure on intangibles?

CRUF absolutely agrees with proposal 9. (i) for specific disclosure requirements for any material expense item for which there is a likely material proportion of growth related expenditure. For example, advertising should be disclosed on a consistent basis between companies, assuming that it is a material line item as advertising expenditure will always combine some maintenance and some growth element.

The CRUF does not agree with 9. (ii) as we believe that this would not be practical for preparers to estimate the split between current and future oriented expenditure, and for auditors to review the split. Whilst the logic is absolutely correct in theory, the ability of a company to estimate the % of an advertising budget which relates to future periods is doubtful. From a user perspective, a time series of the total spent can be viewed in conjunction with the growth rates of the business to derive an estimate of maintenance expenditure.

Question 6 Do you agree with the proposals aimed at improving the quality of information on recognised and unrecognised intangibles in narrative reporting?

The CRUF supports the proposals outlined in the report. As narrative reporting lies outside the scope of the audited financial statements this information will be viewed as supplementary. Metrics provided in the narrative section of reporting can be important inputs in assessing the value of unrecognised intangibles. They must be meaningful, consistent over time and follow the principle of materiality. Audit would be welcomed but not as a prerequisite. Examples of useful metrics include the number of new product launches to gauge the effectiveness of R&D investments, a properly reported churn rate to assess relative customer loyalty and some kind of error frequency as a measure of workforce quality. It is also helpful to discuss time lags and asset lives, where possible.

Question 7 What are your views about how the various participants involved in business reporting could or should contribute to the implementation of the proposals made in the paper?

The CRUF would encourage further outreach to users of financial statements, asking what they would find useful to support their investment decisions.

Question 8 Do you use additional information other than the financial statements when assessing and valuing intangibles? If so, can you please specify what additional information you use?

Analyst presentations are another key source of information about current activities in the intangibles area, for example giving more details about research and development activities which help users assess the likely time lag to product launch and the likely asset life. Another source of additional information is the integrated report which often contains useful information in relation to intangibles. For example, trends in employee attrition is useful information when benchmarking expenditure on training.

Question 9 Do you have any suggestions, other than those put forward in this paper, as to how improving the business reporting of intangibles might be achieved?

The CRUF would like to encourage disclosure for all items of "revenue investment". This should include, where material: research & development, information technology and advertising. Each line item should be defined consistently over time and between companies.

About the Corporate Reporting Users' Forum (CRUF)

The CRUF was set up in 2005 by users of financial reports to be an open forum for learning about and responding to the many accounting and regulatory changes that affect corporate reporting. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters and regulators. CRUF participants include buy and sell-side analysts, credit ratings analysts, fund managers and corporate governance professionals. Participants focus on equity and fixed income markets. The Forum includes individuals with global or regional responsibilities and from around the world, including Australia, Canada, France, Germany, Hong Kong, India, Japan, New Zealand, South Africa, UK and USA.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. In our meetings around the world, we seek to explore and understand the differences in opinions of participants. The CRUF does not seek to achieve consensus views, but instead we focus on why reasonable participants can have different positions. Furthermore, it would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative. This response is a summary of the range of opinions discussed at the CRUF meetings held globally. Local country differences of opinion are noted where applicable.

Participants take part in CRUF discussions and joint representations as individuals, not as representatives of their employer organisations. Accordingly, we sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum and not as representatives of our respective organisations. The participants in the Forum that have specifically endorsed this response are listed below.

(Signatures)

Jeremy Stuber

Greg Collett
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